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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington DC 20554

In the matter of Implementation of the Telecommunications Act of 1996 Accounting Safeguards under the Telecommunications Act of 1996	DOCKET FILE COPY ORIGINAL CC Docket No. 96-150

COMMENTS OF AMERITECH

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SUMMARY

The Commission's Joint Cost Rules were adopted as part of Computer III to counteract what was perceived as the opportunity and incentive on the part of monopoly carriers to allocate to their regulated operations costs that properly should have been attributed to their nonregulated, competitive businesses. Under monopoly rate-of-return regulation, it was believed that misallocations could permit a carrier to reduce the prices on its competitive services without affecting the carrier's overall profitability, since revenues forgone from the competitive service would be recovered dollar-for-dollar from the captive customers of the regulated service.

The shift to price-caps regulation, together with the new emphasis on local competition under the Telecommunications Act of 1996, have combined to blunt the original purpose of the Joint Cost Rules. Today, Ameritech operates under price caps, with no sharing, not only in the federal jurisdiction, but also in all five of its states. Under such circumstances, an incumbent BOC can no longer receive an immediate rate increase resulting from the over-allocation of costs to its regulated service. And, while it may be possible to show theoretically that even under price caps, increased costs can eventually find their way into the

regulated rates at some unknown future time, the incumbent BOC's pricing decisions will be determined by its view of what immediate outcomes are most likely, rather than by such long-run theoretical possibilities.

Moreover, the new Act mandates substantial competition in providing local exchange services; so, even if an incumbent carrier were still able to raise its regulated rates to reflect a cost misallocation, it might succeed only in driving its customers into the waiting arms of its competitors. That prospect further deadens the incentive to misallocate costs, and in this regard it makes no difference that the incumbent carrier will have the lion's share of the regulated customers as competition begins; it is the prospect of future losses, rather than concern over past losses that have (or have not yet) occurred, that will motivate the incumbent's actions.

Accordingly, the unnatural incentives that led to the adoption of the Joint Cost Rules have been abruptly attenuated by the advent of no-sharing price caps and by the increased likelihood of a competitive local exchange market under the Telecommunications Act. Since those rules have lost their original usefulness in protecting consumers and competitors, they are an appropriate subject for the regulatory forbearance that is required by Section 10 of the Act in such circumstances. And even if the Commission does not forbear from enforcing the rules in their entirety, it should adopt the simplified and streamlined form of the rules proposed in the Comments being filed simultaneously by the United States Telephone Association, with which Ameritech concurs.

Furthermore, if the Commission decides nevertheless to retain the present Joint Cost Rules as a redundant double protection against the risks of cross-subsidy, it should not adopt the modification of the affiliate transaction rules that was originally proposed in 1993 in CC Docket 93-251 and which is now tentatively proposed as part of the present rulemaking. As Ameritech explained in 1993, the changes in question would merely make the rules more burdensome. This would contravene the deregulatory mandate of the 1996 Act. Accordingly, in the absence of forbearance or simplification, the existing rules, which have served their purpose well and are familiar to the Commission, the carriers, and their competitors, should remain as they are, and will be more than adequate to achieve the Commission's purposes.

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I. Introduction

Ameritech[1] hereby responds to the Commission's Notice of Proposed Rulemaking released July 18, 1996, in which the Commission proposes to examine what accounting safeguards are necessary as Sections 260 and 271–276 of the Telecommunications Act of 1996 are implemented. The stated purpose of the proceeding is to "... establish accounting safeguards to constrain potential cost misallocation and discrimination

[1] Ameritech comprises Illinois Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Michigan Bell Telephone Company, The Ohio Bell Telephone Company, Wisconsin Bell, Inc., and various affiliates.

against competitors" (NPRM at ¶ 6). The Commission seeks comment on whether its current rules should be applied as they are, applied with modifications, or eliminated, or whether other, less detailed accounting would be sufficient to achieve the aims of the Act (NPRM at ¶¶ 11–12). The NPRM tentatively concludes that the current rules should be applied, with modifications.

Ameritech recognizes that the Commission has applied its accounting safeguards to both the BOC provision of out-of-region interexchange[2] and international[3] services and may, in an abundance of caution, have a predilection for the same action in this proceeding and in the BOC in-region proceeding.[4] Ameritech, however, urges the Commission to evaluate the continued application of any rule on the basis of its practical

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[2] In the Matter of Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services, CC Docket No. 96-21, Report and Order, FCC 96-288 (released July 1, 1996) at ¶ 22.

[3] *In re* NYNEX Long Distance Co., *et al.*, Applications for Authority Pursuant to Section 214 of the Communications Act of 1934, as amended, to Provide International Services from Certain Parts of the United States to International Points through Resale of International Switched Services, ITC-96-125, etc. (released July 24, 1996), at ¶ 20.

[4] *In re* Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, . . . [etc.], Notice of Proposed Rulemaking, CC Docket 96-149, released July 18, 1996 (hereinafter referred to as "Non-Accounting Safeguards Notice") at ¶¶ 130–152; See also Docket 96-152, released July 18, 1996, at ¶ 7.

implications. In those instances where the consumer derives no benefit, the Commission should eliminate the rule or, at a minimum, should adopt streamlined rules which are less intrusive.

II. The Current Joint Cost Rules Should Be Eliminated or Streamlined.

The Commission's current accounting safeguards, which are codified in the Rules at Part 64, Cost Allocations, and in Section 32.27, Transactions with Affiliates (collectively referred to as the "Joint Cost Rules"), exceed the statutory requirements of the Telecommunications Act of 1996. Those rules were adopted to counteract what was perceived as the opportunity and incentive on the part of monopoly carriers to allocate to their regulated operations costs that properly should have been attributed to their nonregulated, competitive businesses. Under monopoly rate-of-return regulation, it was believed that misallocations could permit a carrier to reduce the prices on its competitive services without affecting the carrier's overall profitability, since revenues forgone from the competitive service would be recovered dollar-for-dollar from the captive customers of the regulated service.

These rules have now outlived their usefulness. Ameritech, of course, agrees with the Commission (NPRM at ¶¶ 11, 121) that the threshold issue is the continued applicability of the Joint Cost Rules and that the outcome of this proceeding should be shaped by the Commission's price cap regulation. Ameritech concludes, however, that the Commission should forbear from regulation for no-sharing price cap carriers. Ameritech has already shown, in its Comments in response to the Commission's NPRM regarding allocation of the costs of video services,[5] that continued application of Part 64 of the Commission's rules to pure price cap carriers is unnecessary and that therefore the Commission should exercise its general powers under Section 10 of the Act, which allows it (and indeed requires it) to forbear from enforcing regulations and statutory provisions that have become obsolete.

A. *Carriers Under the No-Sharing Price Cap Option Have No Incentive To Misallocate Costs.*

The shift to price-caps regulation, together with the new emphasis on local competition under the Telecommunications Act of 1996, have combined to blunt the original purpose of the Joint Cost Rules by removing the incentive to misallocate costs to its regulated business. However, the

[5] *In re* Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, CC Docket No. 96-112, Notice of Proposed Rulemaking, FCC 96-214, released May 10, 1996 (hereinafter cited as "Video Allocation Notice"), Comments of Ameritech, filed May 31, 1996.

NPRM attempts to describe four circumstances under which a carrier might still have an incentive to misallocate costs to its regulated business: (1) rate-of-return regulation, (2) price caps with sharing at either the interstate or state level, (3) price caps that may be adjusted in the future, and (4) whenever a carrier's "entitlement to any revenues may be affected by" its regulated costs.[6]

These points are not persuasive. It is true, of course, that a carrier might arguably have an incentive to misallocate costs under rate-of-return regulation, or under price caps with sharing, because the carrier's rates or sharing amounts are dependent on cost allocations. Ameritech, however, has selected the no-sharing option for federal regulation and is operating under pure price caps in all five of the states where it is an incumbent local exchange carrier. Hence, points (1) and (2) could not possibly apply in the case of Ameritech.

The Commission provides very little meaning to the third and fourth circumstances outlined in the NPRM (even though it refers to a similarly obscure circumstance in CC Docket 96-149 as "the possibility of future

[6] NPRM at ¶ 6; *see also* Non-Accounting Safeguards Notice, *supra* note 4, at ¶ 7.

re-calibration of price cap levels"[7]). Some indication is provided in the definition of pure price caps as the permanent elimination of sharing, claims for exogenous treatment, and the need for the Commission to consider adjustments to productivity factors (NPRM at ¶ 121).

There is no need to defer the elimination of the Joint Cost Rules until sharing is eliminated permanently (NPRM at ¶ 24) because once a company has elected the no-sharing option, costs do not impact rates. With respect to the Commission's concerns on the carrier's having the option of electing different productivity factors annually as an incentive to shift costs (NPRM at ¶ 124), all the Commission need do is specify that as long as a carrier elects the no-sharing productivity factor, the Joint Cost Rules do not apply.[8]

There is also no need to defer the elimination of the Joint Cost Rules until exogenous treatment is eliminated permanently. The Commission has recognized that exogenous treatment is a remnant of rate-of-return regulation used to transition to market based rates.[9] Allowed exogenous

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[7] Non-Accounting Safeguards Notice, *supra* note 4, at n.258.

[8] Video Allocation Notice, *supra* note 5, Comments of Ameritech, filed May 31, 1996, at 6)

[9] *In re* Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 F.C.C.R. 8961 (released April 7, 1995) (hereinafter cited as "Price Cap Order"), at ¶¶ 298–299.

treatment has been made for those items that had a relation to rates in effect as of July 1, 1990, such as inside wire amortization and the amortization of depreciation reserve deficiencies. New claims for exogenous treatment must satisfy the tests of being beyond the carrier's control and not reflected in the GNP-PI and, for accounting changes, the change must also be an economic cost affecting cash flow. As a result, exogenous treatment is not something routinely granted and any supposed cost misallocations would most certainly have to be fully explained and justified before any impact on rates would be granted.

With respect to future adjustments to the productivity factor, the total factor productivity ("TFP") that has recently been proposed by the United States Telephone Association ("USTA") is a moving average X-Factor that would eliminate the need for periodic review and revision.[10] The Commission has tentatively concluded that this is a significant benefit with respect to eliminating the need for periodic updates.[11] Further, the Commission has tentatively concluded that a property of an

[10] *In re* Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, 10 F.C.C.R. 13659 (released Sept. 27, 1995) (hereinafter cited as "LEC Price Cap 4th Further Notice"), comments of the United States Telephone Association, filed Jan. 16, 1996, at 34-37.

[11] LEC Price Cap 4th Further Notice, *supra* note 10, at ¶ 96.

X-Factor, in addition to a TFP methodology, should be that it routinely and automatically be recalculated as a moving average.[12]

In addition, to the extent that the Commission may decline in this proceeding to eliminate or streamline the Joint Cost Rules because the price cap rules are still in an interim state, it should commence a new proceeding to reconsider the Joint Cost Rules as soon as the price cap rules (or access reform) are finalized.

Finally, with respect to the Commission's fourth circumstance, it is unclear to which "entitlements" and "revenues" the Commission may be referring. However, whatever may be included within that category, it is certain that the connection between a misallocation of costs and any corresponding increase in regulated rates would be so remote in likelihood, and so far removed in time, that it could not form the basis of the carrier's pricing decisions. It will be the most probable outcomes, rather than mere theoretical possibilities, that will determine any carrier's incentives. In any event, Ameritech is under no-sharing price caps in all its jurisdictions, and the danger of monoply cross-subsidy is eliminated in such circumstances.

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[12] Price Cap Order, *supra* note 9, at ¶ 145.

B. Predatory Behavior Is Unlikely.

Ameritech agrees with the tentative conclusion that even with BOCs under rate-of-return regulation, predatory behavior is unlikely to occur (NPRM at ¶ 16). The likelihood is even less for no-sharing price cap carriers as any perceived cost misallocations cannot be passed on in higher rates. Accordingly, in response to the question posed in the NPRM, Ameritech submits that the opportunities to engage in predatory behavior should not affect the Commission's decisions in this proceeding.

C. There Should Be No Exogenous Treatment for Cost Allocations.

Comment is requested (NPRM at ¶ 123) on the interpretation of Section 61.45(d) of the Rules, which requires an exogenous change for the reallocation of investment from regulated to nonregulated. Section 61.45(d) pertains to a true-up of misforecasted shared Central Office Equipment (COE) and outside plant (OSP) investment and should continue to be interpreted as such.[18] With respect to embedded or new

[18] *In re* Separation of Costs of Regulated Telephone Service from Costs of Non-Regulated Activities, 2 F.C.C.R. 1298 (1987), at ¶¶ 170–71; *on reconsideration,* 2 F.C.C.R. 6283 (1987), at ¶ 64; *on further reconsideration,* 3 F.C.C.R. 6701 (1988), at ¶¶ 29–41; Video Allocation Notice, *supra* note 5, Ameritech Reply Comments, at 8. In fact, since the exogenous treatment of shared investment reallocation was based on a cost-of-service mode of regulation, its continuance is unnecessary for no-sharing price cap carriers.

investment for telemessaging service, exogenous treatment should only be required to the extent that the investment is part of the shared forecast investment where a true-up is warranted. (Pursuant to Section 260(c) of the Act, telemessaging is defined to include voice mail. As such, it is already a nonregulated service covered by the Joint Cost Rules (NPRM at ¶ 30)).

There should be no exogenous treatment for cost allocations besides that currently required in the rules. As discussed in USTA's Comments, the USTA TFP methodology reflects the economies of scale achieved through provisioning of regulated and nonregulated services over a shared system. An exogenous charge would result in a double reduction of rates for the same investment and would be arbitrary and capricious.

D. The Proposals Exceed the Requirements of Section 254(k).

The Commission's proposals exceed the requirements of Section 254(k), Universal Service, on non-competitive services subsidizing competitive services (NPRM at ¶ 125). The operative requirement in Section 254(k) is that the Commission adopt any "necessary" cost allocation rules and presumes that services are based on cost of service/rate of return. Price cap regulation with no sharing in both the state and interstate jurisdictions renders any "necessary" cost allocations unnecessary.

E. The Commission Has Ample Authority To Forbear from Regulation Under Section 10 of the Act.

The Commission has ample authority to invoke Section 10 of the Act and forbear from regulation. Section 10 of the Act provides that the Commission must forbear from applying any regulation if it determines that enforcement of the regulation is "not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory"; that "enforcement of such regulation or provision is not necessary for the protection of consumers"; and that "forbearance from applying such provision or regulation is consistent with the public interest".

Since the Joint Cost Rules do not impact rates for carriers that have elected the no-sharing productivity factor, they are not necessary to ensure just and reasonable rates and for the protection of consumers. (As already noted, Ameritech has selected the no-sharing option for federal regulation and operates under pure price caps in all five of the states where it is an incumbent local exchange carrier.) The elimination of unnecessary administrative costly rules are self-evidently in the public interest on the basis of economic efficiency.[14]

F. Less Detailed Accounting Safeguards Will Be Sufficient To Fulfill Statutory Mandates.

If a determination is made that forbearance is not a public policy option at this time, less detailed accounting safeguards are sufficient to fulfill statutory mandates. The Joint Cost Rules are not cited in the Act except by implication in two instances. First in reference to Cost Allocation Manual (CAM) filings where the frequency was reduced from quarterly to annually (Section 11(b)(2)(B)), and second in connection with the CI-III nonstructural safeguards associated with payphone (Section 276(B)(1)(c)). Consistent with the Act's mandate to foster a national deregulatory policy framework, less detailed accounting should be adopted. The Commission has wide discretion and authority to adopt less detailed and intrusive rules and should use this opportunity to do so.

The NPRM seeks comment on whether requirements similar to those adopted under CI-II should be adopted to implement Section 272(b)(5),

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[14] Ameritech proposed specific rule changes in Attachment A to its comments filed in response to the Video Allocation Notice, *supra* note 5; those proposed changes are incorporated herein by reference.

which requires transactions be conducted on an arm's length basis for manufacturing, origination of interLATA, and interLATA information services. Ameritech maintains that the CI-II full structural separation requirements are incompatible with the Act and would be a regressive step backwards. Ameritech maintains that the streamlining proposals contained in the attachment to the comments are fully consistent with the intent and requirements of the Act and would ensure that transactions would be conducted at arm's length. The USTA streamlining proposals should be adopted for both the separated and integrated operations of the Act.

As will be detailed in USTA's Comments, the streamlining proposal modifies the affiliate valuation standards by eliminating the asymmetrical standard for asset transfers and eliminating the substantial requirement for using prevailing price for services.

Additionally, USTA's simplification proposal eliminates the shared forecast investment rules, simplifies the Part 64 administrative process, and reduces the frequency of the independent Part 64 audit.

III. The Current Rules Need No Further Augmentation.

A. *The Commission's Proposed Modifications of the Affiliate Transaction Rules Are Unnecessary.*

Nearly three years ago, in CC Docket 93-251, the Commission proposed various changes to the affiliate transaction rules, but they were never adopted.[15] It is now proposed (NPRM at ¶ 77) that similar modifications be made effective and be applied to transactions between a BOC and its manufacturing, interLATA telecommunications, and interLATA information services affiliate. Ameritech opposed these modifications three years ago and opposes them even more fervently today. The affiliate transaction rules, codified at Section 32.27, specify the hierarchical valuation standards for service and asset transactions between a regulated carrier and its nonregulated affiliate. Services are valued at tariff rate, prevailing price, or fully distributed cost ("FDC"). Assets are valued at tariff rate, prevailing price, or the higher of estimated fair market value or net book cost if transferred out of regulation and the

[15] *In re* Amendment of Parts 32 and 64 of the Commission's Rules To Account for Transactions Between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rulemaking, CC Docket 93-251, 8 F.C.C.R. 8071 (Oct. 20, 1993) (hereinafter cited as "Affiliate Transactions Notice").

lower of estimated fair market value or net book cost if transferred into regulation (NPRM at ¶ 71, Section 32.27).

The NPRM proposes uniform valuation methods for affiliate transactions to prevent carriers from imprudent acts of buying and selling services at less than fair market value. Regulated service ratepayers could be harmed "if" the increased costs are reflected in rates and non-affiliated carriers could be harmed by being put at a competitive disadvantage (NPRM at ¶ 77). The NPRM proposes to <u>minimize</u> this theoretical harm by requiring both assets and services not available at a tariff rate to be provided at the higher of estimated fair market value or FDC if transferred out of regulation, and the lower of estimated fair market value or FDC if transferred into regulation (NPRM at ¶ 78).

The NPRM further proposes the elimination of the use of prevailing price as a valuation standard for assets or services because it may not reflect the fair market value of affiliate, as opposed to non-affiliate, transactions. Affiliates could charge BOCs inflated prices, resulting in increased revenue, thereby disadvantaging the provision of competitive assets and services (NPRM at ¶ 81). Presumably, the inflated prices charged the BOCs would be passed onto regulated ratepayers in higher rates.

The proposed modifications are not necessary to ensure compliance with Section 272(b)(5) of the Act, which requires that transactions be conducted "at arm's length". They are unnecessary for several reasons. Docket 93-251 was initiated at a time when BOCs were under rate-of-return regulation or were under price caps with sharing. Since the time of Docket 93-251, we now have price caps with no sharing and the Telecommunications Act, which proposes a deregulatory national policy framework. In addition, the Commission then maintained that the affiliate transaction rules were necessary in connection with a LEC's sharing obligation and, since AT&T was under no-sharing price caps, the affiliate transaction rules should not apply to AT&T.[16] Why that analysis has changed remains unexplained in the current NPRM. Finally, the greater emergence of competition will serve as a deterrent to the type of discrimination or subsidy that is at issue.

Ameritech's initial arguments in Docket 93-251 are even more valid today: the need to determine estimated fair market value for every service is administratively costly, subjective,[17] and difficult to audit, with no

[16] Affiliate Transactions Notice, *supra* note 15, at ¶¶ 100–103.

[17] *See* Affiliate Transactions Notice, *supra* note 15, Comments of Coopers & Lybrand, filed Dec. 9, 1993, at 4.

countervailing benefits, and it is a reversal of previous Commission conclusions on this matter.[18]

The fundamental reason to reject the proposal is, however, its practical insignificance. As already discussed, in order for cross-subsidy to be effective, a carrier must (1) be able to shift costs from nonregulated to regulated, (2) incorporate the increased costs into higher rates, and (3) retain its customers notwithstanding the higher prices. Under no-sharing price caps, (1) and (2) cannot be done, and higher rates cannot be sustained in the face of competition. The fundamental premise of the Commission's proposal, therefore, (*i.e.*, increased costs passed on to ratepayers through higher rates) is flawed, and provides no basis for the imposition of changed, costly, and burdensome affiliate transaction rules.[19]

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[18] Ameritech Comments in response to the Affiliate Transactions Notice, *supra* note 15, filed December 10, 1993.

[19] *See* Video Allocation Notice, *supra* note 5, Affidavit of J. Gregory Sidak, attached to the comments of the United States Telephone Association, filed May 31, 1996.

B. If Neither Forbearance Nor Simplification Is Adopted, the Rules Should Be Left As They Are.

If a determination is made that forbearance or streamlining is not a public policy option at this time, the rules should be left as they are. The Commission has stated (NPRM at ¶ 12) that "those urging that we adopt more detailed accounting safeguards than those in our current rules or those specifically mandated by the 1996 Act bear a heavy burden of persuading us to adopt such safeguards." The Commission's conclusion here is plainly the right one. The Joint Cost Rules were adopted as a comprehensive series of accounting safeguards in the Computer III proceeding effective January 1, 1988. The Commission and industry have years of experience in administering and reporting on the application of the rules including a required annual independent audit in accordance with Section 64.904 and FCC and state commission audits. The systems are in place and the safeguards are working as they were designed to do.[20] As a result, the Commission should not make the rules more stringent.[21]

[20] *See* Non-Accounting Safeguards Notice, *supra* note 4, at ¶ 146.

[21] It is worth emphasizing again, however, that the Joint Cost Rules were adopted when all carriers were regulated under rate-of-return and cost misallocations had practical significance, which is no longer the case for no-sharing price cap carriers.

Ameritech agrees with the NPRM (at ¶ 28) that there would be substantial costs in the redesign of internal systems if another fundamentally different approach were adopted. The Joint Cost Rules were the subject of a lengthy and voluminous proceeding and it is doubtful that the costs associated with the adoption of a different approach would be justified by the benefit.

C. Safeguards for Integrated Operations Are Adequate.

1. Telemessaging (Section 260(a)(1)).

Ameritech also agrees with the NPRM (at ¶ 30) that telemessaging is already covered by the Joint Cost Rules and that their application guards against subsidies.

The NPRM also states (at ¶¶ 31–32) that the BOC provision of telemessaging may result in the reallocation of plant from regulated to non-regulated, citing the Joint Cost forecast rules for shared investment. Ameritech does not disagree with the application of this rule to shared telemessaging plant. The NPRM (at ¶ 123) also asks for comment on whether all such reallocations should result in an exogenous adjustment to lower the PCI. Ameritech maintains that reallocations resulting in exogenous treatment are limited to those associated with Section 64.901(b)(4) of the Commission's rules.

2. INCIDENTAL INTERLATA TELECOMMUNICATIONS AND INFORMATION SERVICES (SECTION 271(G)(H)).

Ameritech agrees with the NPRM (at ¶ 38) that Joint Cost Rules are sufficient to protect against adverse effect upon exchange service ratepayers or upon competition.

The NPRM proposes two accounting alternatives if a BOC chooses to provide certain interLATA services on an integrated basis. The first is the creation of a separate regulated category in addition to local exchange and access service within the cost allocation system and the second is to treat these regulated services as nonregulated for Title II accounting purposes (NPRM at ¶ 39). The Commission need not adopt either alternative proposed because if a service is regulated, the existing Part 36 jurisdictional separation rules and Part 69 access rules apply and, if the service is nonregulated, the Joint Cost Rules apply.

Ameritech disagrees with the accounting to implement Section 272(e)(3) on imputed access charges as a credit to the regulated exchange access revenue account with the expense assigned to nonregulated (NPRM at ¶ 41). The accounting requirements for regulated